

Office of Chief Counsel
Internal Revenue Service
Memorandum

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FCMutter

date: June 10, 2008

to:

Exam Group
Revenue Agent

from: Area Counsel
(Small Business/Self-Employed:Area 1)

subject: ("Taxpayers")

This memorandum responds to your request for assistance. This memorandum should not be cited as precedent.

ISSUE:

Whether the taxpayers are entitled to relief under I.R.C. § 1341 for 2005 and subsequent years for payments they made to settle qui tam ("whistle blower") lawsuits.

CONCLUSION:

The complaints giving rise to the causes of action against taxpayers should be obtained and reviewed along with the evidence supporting the claims. If the taxpayers engaged in intentional wrongdoing, they would not be entitled to relief under I.R.C. § 1341. The taxpayers may be entitled to relief if they made deductible payments pursuant to a settlement agreement negotiated in good faith by the parties to establish liability.

FACTS:

The taxpayers provided consulting and administrative services to hospitals with alcohol and substance abuse programs. The United States contended that, during the period from _____ to _____, the taxpayers entered into "administrative

services agreements” with hospitals that paid taxpayers for providing the hospitals with referrals. In connection with these agreements, the taxpayers allegedly “knowingly caused the hospitals to submit to the United States false or fraudulent claims for payment to the [redacted] for alcohol and substance abuse services the hospitals provided to patients referred by [taxpayers].”

On [redacted], [redacted], who owned the majority of the shares of both taxpayers, entered into an agreement with the United States and [redacted] to settle whistle blower lawsuits. [redacted] brought a lawsuit, in which the United States intervened in part, in the United States District Court for the [redacted] under the whistle blower provisions of the False Claims Act, 31 U.S.C. §§ 3729-3733. The United States also filed a complaint against the taxpayers under the whistle blower provisions of the False Claims Act.

In the settlement agreement, the taxpayers did not admit to any wrongdoing or improper conduct on their part. Nor did the United States concede that its claims had no basis. The parties reached the settlement in order “to avoid the delay, uncertainty, inconvenience, and expense of protracted litigation.” Pursuant to the agreement, the taxpayers agreed to pay the United States \$ [redacted], plus interest. The settlement payment chart shows a payment of \$ [redacted] on [redacted] and a payment of \$ [redacted], plus accrued interest, on [redacted]. The chart also shows that the taxpayers were to make two payments of \$ [redacted] each, plus accrued interest, in both [redacted] and [redacted] and a final payment of \$ [redacted], plus accrued interest, in [redacted]. The United States agreed to pay \$ [redacted], [redacted] % of the settlement amount, to [redacted] as the whistle blower.

The taxpayers are Sub-Chapter S corporations owned [redacted] % by [redacted] and [redacted] % by [redacted] (collectively “the shareholders”). On their federal income tax returns, Forms 1120S, for taxable year [redacted], taxpayers reported as other deductions “refund of prior years income.” Taxpayer [redacted] deducted \$ [redacted], while taxpayer [redacted] deducted \$ [redacted]. The total of these amounts, \$ [redacted], equals the payments that the taxpayers were to make in pursuant to the settlement agreement.

These deductions increased the ordinary business losses for both taxpayers. The losses flowed to and were deducted by the shareholders on their federal income tax returns, Forms 1040, for taxable year [redacted]. Shareholder [redacted] reported these losses [redacted] as non-passive and without limitation. Shareholder [redacted] reported the losses from the taxpayers [redacted] as passive. These losses were limited because of the passive activity loss rules.

In a memorandum dated [redacted] to taxpayers’ shareholders, counsel for the taxpayers represented that the settlement amount of \$ [redacted] was based on the calculation of the profits to the taxpayers during the [redacted] to [redacted] period from the [redacted]

“administrative services agreements.” The settlement agreement thus represented a “disgorgement of profits.”

To support this claim, the taxpayers’ counsel attached to his memorandum a copy of a letter he had written, with evidence of its transmittal and receipt, to Assistant United States Attorney _____, dated _____, confirming with

that the settlement amount reflected a “disgorgement of profits” and that letter to the United States Department of Justice recommending the settlement described the settlement in that way.

LAW AND ANALYSIS

I.R.C. §1341(a) applies if a taxpayer is allowed a deduction for repayment of an item that was included in gross income in a prior year because the taxpayer appeared to have an unrestricted right to the income item in the year of receipt. In the event the repayment exceeds \$3,000.00, taxpayers may take a credit in lieu of a deduction in the year of repayment equal to the amount of tax they originally paid on the income item in the year of receipt, if the credit provides more benefit than the deduction.

Treas. Reg. §1.1341-1(b) explains how the tax is computed in the year of repayment in the event that the repayment exceeds \$3,000.00. The tax in the year of repayment is the lesser of: 1) the tax computed with the repayment treated as a deduction; or, 2) the tax computed with the tax originally paid on the repayment amount treated as a credit. The credit can result in a tax overpayment in the year of repayment. I.R.C. §1341(b)(1). The deduction can result in a net operating loss. I.R.C. §1341(b)(4).

Case law has interpreted how I.R.C. § 1341 applies in situations involving wrongfully or allegedly wrongfully obtained funds. In Angel D. Perez and Dorothy E. Perez v. United States, 553 F.Supp. 558 (D. Fla. 1982), the plaintiff made restitution to his prior employer of kickback payments that he had reported in income in the year received. The court reasoned that the plaintiff clearly breached his fiduciary duty when he accepted those payments and could therefore not apply I.R.C. §1341 to the restitution of the kickback payments. The court held that, although ill-gotten gains were included in gross income under I.R.C. §61, I.R.C. §1341’s “unrestricted right” language must be read to exclude from its coverage all those who receive earnings knowing themselves to have no legal right thereto.”

In Barrett v. Commissioner, 96 T.C. 713 (1991), petitioner husband repaid \$54,400.00 in 1984 to settle a claim alleging that he used insider information to buy and sell securities. The Tax Court found that the petitioners were entitled to I.R.C. § 1341 relief for the repayment because, according to the Tax Court, “while maintaining his innocence,” petitioner husband disgorged these funds as part of an arms-length settlement of a civil lawsuit. These types of settlements “have substantially the same effect as judgments”

and provide sufficient proof of a taxpayer's ultimate lack of unrestricted right to the income and the applicability of I.R.C. §1341.

The Service disagreed with the Barrett decision (AOD-1992-08), noting that the Tax Court's reasoning was incomplete because the court failed to determine if a "nexus" existed between the claim of right and the repayment. The Service also noted that, although it did not recommend appeal, it would seek to distinguish the Barrett case on its facts in the future.

In George C. and Elaine E. Parks v. United States of America, 945 F.Supp. 865 (W.D. Pa. 1996), the plaintiffs repaid proceeds received from the sale of their home security business in connection with the settlement of fraud-related litigation arising from the sale. In moving for summary judgment, the plaintiffs argued that there were no disputed material facts and that Barrett controlled. The Parks Court disagreed, noting that "the Tax Court [in Barrett] implicitly accepted the notion that it appeared that the taxpayer had an unrestricted right to the funds."

The court refused to do that in Parks because to do so "would conclusively eliminate the government's opportunity to demonstrate that the income was derived from fraud, and that a corresponding refund would reward the fraud, contrary to section 1341." The court then denied the plaintiffs' summary judgment motion, noting that "taxpayers may be required to undergo trial by operation of section 1341 to vindicate [their unrestricted right to income], even though they may have settled direct claims of liability for the same alleged wrongdoing."

In Stephen S. Wang, Jr. v. Commissioner, T.C. Memo. 1998-389, the Tax Court had an opportunity post-Barrett to revisit the applicability of I.R.C. §1341 in the context of repayment of funds received from wrongdoing or alleged wrongdoing. In this case, the Service argued that petitioner was not entitled to I.R.C. § 1341 relief for disgorging profits related to sale of insider information because: 1) he never included the insider trading proceeds in his income; 2) he did not receive the insider trading income under a claim of right (that he did not have an unrestricted right to the income when he received it); and, 3) illegally obtained income does not, per se, give rise to a claim of right. Petitioner argued Barrett controlled, as that case was factually similar, and that he was therefore entitled to relief under I.R.C. §1341.

The Tax Court reasoned that, since the petitioner in Wang did not include the \$125,000.00 in gross income in 1987, he was not entitled to relief under I.R.C. §1341 for the disgorgement of these funds in 1988. In distinguishing Barrett, the Wang opinion reasoned that in Barrett the issue concerned whether the taxpayer had the legal obligation to repay amounts previously included in income. In Wang, by contrast, the issue concerned "the claim of right or the appearance of the unrestricted right to income" in the year of receipt, not the legal obligation to repay the funds.

The court in Wang stated in dicta that it did not believe that taxpayers with illegal income were per se not entitled to the benefits of I.R.C. §1341 and that:

With respect to each taxpayer it would be necessary to decide whether his circumstances meet the requirements of I.R.C. §1341. Embezzlers do not meet the claim of right requirement under I.R.C. §1341 because there was no claim of right, not because the income or gain was illegally obtained. I.R.C. §1341 only applies if the taxpayer appeared to have an unrestricted right to the income in the year of receipt.

In our case, you should confirm through review of transcripts and tax returns that the taxpayers reported gross income of at least \$ _____ in the period from _____ to _____. Under Wang, the taxpayers, as a threshold matter, would not be entitled to apply I.R.C. §1341 if they did not include in gross income the amounts repaid in _____ and to be repaid in subsequent years.

You should also obtain a copy of _____ memorandum to the Department of Justice recommending settlement. Taxpayers' counsel references this memorandum in his memorandum to the taxpayers' shareholders dated _____ and in his letter to Assistant United States Attorney _____ dated _____. You will want to confirm that the AUSA truly understood the settlement as reflecting a "disgorgement of profits."

Assuming that the AUSA understood the settlement that way and the transcripts show gross income of at least \$ _____ for the _____ to _____ period, the next step in the inquiry is to investigate the nature of the claims asserted against the taxpayers by

and the United States in their complaints under the False Claims Act. The complaints should be reviewed and the evidence to support the claims should be obtained and evaluated. We can assist you with this review.

If, after this review, it appears as if taxpayers engaged in intentional misconduct, even though they settled their liability, we would recommend that they not be entitled to relief under I.R.C. § 1341. If, however, after the review, you determine that there is no evidence of intentional wrongdoing on the part of taxpayers, we would recommend that the agreement be respected as establishing the taxpayers' liability and their entitlement to relief under I.R.C. § 1341. In that case, you would need to determine whether the taxpayers and their shareholders properly reported, in accordance with Treas. Reg. §1.1341-1(b), the tax consequences of these repayments on their federal income tax returns.

Please call Fred Mutter at (917) 421-4747 if you have any further questions.

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By: _____
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cc: Area Counsel